The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

September 20, 2002

Comment Letter on SEC Corporate Reform Rules, September 2002

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Mr. Paul F. Roye
Director
Division of Investment Management
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Dear Mr. Roye:

The Investment Company Institute[1] would like to express its views with respect to the Securities and Exchange Commission's anticipated rulemaking to implement two provisions of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act" or the "Act").[2] The first provision, Section 406 of the Act, directs the Commission to issue rules to require each issuer to disclose whether or not it has adopted a code of ethics for senior financial officers. The second provision, Section 407 of the Act, directs the Commission to issue rules to require each issuer to disclose whether or not its audit committee has at least one member who is a "financial expert," as such term is defined by the Commission.

The Institute strongly supports the intent of these provisions—to enhance the ethical standards of public companies and their senior financial officers and to bolster the effectiveness of public company audit committees. It is important for the Commission to recognize, however, that investment companies differ in many important respects from operating companies. Accordingly, we recommend that the Commission, in developing rules to implement these provisions, take into account both existing requirements for investment companies and the unique nature of investment company financial statements. We have provided below our specific comments on each of these provisions.

Code of Ethics for Senior Financial Officers

Section 406 of the Act directs the Commission to promulgate rules to require each issuer to disclose whether or not it has adopted a code of ethics for senior financial officers, and if not, why not. This provision further provides that the term "code of ethics" means such standards as are reasonably necessary to promote: honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; full, fair, accurate, timely, and understandable disclosure in the

periodic reports required to be filed by the issuer; and compliance with applicable governmental rules and regulations.

We request that the Commission determine that if investment companies comply with related requirements under the Investment Company Act, they would be deemed to satisfy any new Commission requirement under Section 406 with respect to codes of ethics. The recommended approach would be consistent with recent action taken by the New York Stock Exchange with respect to proposed code of ethics requirements for NYSE-listed companies. The NYSE determined that new code of ethics requirements should not apply to closed-end investment companies "given the pervasive federal regulation applicable to them."[3]

In adopting rules under Section 406, the Commission should be mindful of the fact that, unlike other issuers, investment companies already are subject to a pervasive system of substantive regulation, including code of ethics requirements, under the Investment Company Act. In particular, Rule 17j-1 under the Investment Company Act generally requires every registered investment company to adopt a written code of ethics with provisions reasonably necessary to prevent investment company personnel from engaging in fraudulent personal trading activities and to institute procedures to prevent violations of the code.[4] Among other things, Rule 17j-1 requires investment advisory personnel to provide an initial holdings report listing all securities beneficially owned, quarterly transaction reports, and an annual holdings report.[5] It also requires that each investment company's code of ethics, as well as any material changes thereto, be approved by the investment company's board, including a majority of independent directors.[6] The board's determination needs to be based partly on a certification from the investment adviser that reasonably designed procedures have been adopted to prevent violations of the code of ethics. The investment company's board must annually receive a written report reaffirming the certification and describing material violations of the code and any sanctions imposed.[7]

In addition to the comprehensive code of ethics requirements, the Investment Company Act prohibits or restricts various types of transactions between an investment company and its affiliates.[8] These prohibitions and restrictions are designed to prevent insiders from using an investment company to benefit themselves to the detriment of the company and its shareholders. For example, the Investment Company Act prohibits an affiliate of an investment company from borrowing money or other property from the investment company.[9] The Investment Company Act also prohibits an affiliate of an investment company, acting as agent, from receiving compensation from outside sources in exchange for the purchase or sale of any property to or from an investment company.[10] The Investment Company Act also has strict requirements with respect to permissible custody arrangements for investment company assets designed to preserve the assets of investment companies and protect them from abuses by insiders.[11] Furthermore, rules recently adopted to implement Section 302 of the Sarbanes-Oxley Act require appropriate investment company officers to make certifications regarding the establishment and maintenance of disclosure controls and procedures and to certify investment company periodic reports.[12] Compliance with these rules should satisfy the requirement to establish standards reasonably necessary to promote "full, fair, accurate, timely, and accurate disclosure" in fund periodic reports, as contemplated by Section 406.

In light of the foregoing requirements and restrictions applicable to investment companies, we recommend that the Commission determine that investment companies that are in compliance with Rule 17j-1 under the Investment Company Act and other relevant requirements would be deemed to satisfy any new Commission requirement under Section

406.13 We believe that such a determination would be consistent with Congress's mandate that the Commission design such standards "as are reasonably necessary to promote honest and ethical conduct" (emphasis added).14

Disclosure of Audit Committee Financial Expert

Section 407 of the Sarbanes-Oxley Act directs the Commission to issue rules requiring each issuer to disclose whether or not its audit committee includes at least one member who is a "financial expert." If the audit committee does not include at least one member who is a "financial expert," the issuer must disclose the reasons why it does not have such an expert. Section 407 also requires the Commission to define the term "financial expert" and directs the Commission to "consider" various factors in developing this definition. In so directing the Commission, we believe that Congress provided the Commission with the needed flexibility to determine the relevance of particular factors for different kinds of issuers.15

Consistent with this, we recommend that the Commission develop a definition of "financial expert" that takes into consideration the differences between operating companies and investment companies and tailors the definition appropriately for investment companies. Unlike operating companies, the assets of investment companies consist exclusively of investment securities. Further, gains and losses generally are determined by reference to market prices for the fund's securities, which are determined daily. Investment companies do not engage in transactions or have relationships with unconsolidated or off-balance sheet entities. Consequently, the accounting policies employed by funds are relatively straightforward.

Due to the straightforward nature of fund financial statements and accounting policies, investment company audit committees typically do not include directors with accounting or auditing experience. Rather, audit committees for investment companies typically have members with relevant investment company experience or other appropriate business experience. That these persons have provided effective oversight of investment company accounting and auditing processes is evidenced by the absence of reported abuses involving investment company financial statements.

Accordingly, we urge the Commission to define financial expert for investment companies in a way that recognizes the inherent differences between investment companies and operating companies. We believe that this would be fully consistent with the intent of Section 407. Our specific suggestions are detailed below.

Section 407(b) requires the Commission to consider as a factor in defining "financial expert" whether that person has through education and experience as a public accountant, principal financial officer of an issuer, or from a position involving the performance of similar functions an understanding of, or experience in various matters. 16 We believe there are numerous positions, aside from those specifically identified, that would provide relevant knowledge and experience to an investment company "financial expert." Examples would include the chief operating officer of a public company, a business school professor, or a person with experience in managing investments or in investment company operations. Such persons could be expected to have an understanding of generally accepted accounting principles, internal controls, and audit committee functions, consistent with the factors set forth in Section 407(b)(1), (3), and (4). We further believe that providing a different, yet comparable, requirement for investment company financial experts is

consistent with Congress's intent to require at least one audit committee member to have relevant financial expertise to discharge his or her duties.17

By contrast, we believe the factors identified in Section 407(b)(2) are not relevant to investment companies and urge the Commission to omit them from its definition of investment company financial expert. Section 407(b)(2)(A) directs the Commission to consider as a factor in defining financial expert whether that person has experience in "the preparation or auditing of financial statements of generally comparable issuers." This provision appears to be intended to recognize that certain industries (e.g., energy) employ specialized accounting principles and that to possess the relevant expertise to be considered a financial expert, the director should have accounting experience in that particular industry.18 While investment companies utilize industry specific accounting (e.g., daily mark-to-market), their accounting policies and financial statements are relatively straightforward and easily understood as compared to those of operating companies. Accordingly, we believe that having a member of an audit committee with direct experience in the preparation or auditing of financial statements of generally comparable issuers (i.e., investment companies or other pooled investment vehicles) is not necessary to ensure the accuracy of investment company financial statements. This experience should therefore not be a prerequisite for investment company directors to be considered financial experts for purposes of the audit committee.

Similarly, the criteria set forth in Section 407(b)(2)(B) are not relevant to investment company financial expertise. That provision requires the Commission to consider as a factor in defining financial expert whether that person has experience in "accounting for estimates, accruals, and reserves." The provision appears to be intended to address specific abuses witnessed in certain operating companies. Unlike operating companies, however, investment companies accrue income and expenses daily, and, consequently, there is little or no opportunity through "creative" accounting practices for misstating these figures. Investment companies typically do not have reserves (e.g., allowances for losses on receivables that may not be collected). Moreover, investment companies do not employ traditional accounting estimates (e.g., inventory obsolescence, service lives, and salvage values of depreciable assets, warranty costs, etc.). Rather, they price most portfolio securities at market value.19 Accordingly, we do not believe experience with accounting for estimates, accruals and reserves should be required as a prerequisite for an investment company director to be considered a financial expert.

For the reasons stated above, the Institute recommends that the Commission develop a definition of "financial expert" that takes into consideration the differences between operating companies and investment companies. We believe persons with other types of professional experience such as the examples provided above would have an understanding of GAAP, internal controls, and audit committee functions that would enable them to provide meaningful oversight of fund accounting and auditing processes. Our recommended approach would be consistent with Congress's intent, without needlessly forcing investment companies to either make disclosure that raises unjustified negative implications or incur the time and expense associated with recruiting new directors without any overriding benefit for investment company shareholders.

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We appreciate your consideration of our views. Any questions regarding our letter may be directed to the undersigned at 202/326-5815.

Sincerely,

Craig S. Tyle
General Counsel

cc: The Honorable Harvey L. Pitt, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
Alan L. Beller, Director
Division of Corporation Finance
Giovanni Prezioso, General Counsel
Office of General Counsel

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,973 open-end investment companies ("mutual funds"), 514 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.363 trillion, accounting for approximately 95 percent of total industry assets, and over 87.8 million individual shareholders.

2 Pub. L. 107-204, 116 Stat. 745 (2002).

3 See Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee As Approved by the NYSE Board of Directors August 1, 2002. Under the NYSE's proposal, each NYSE-listed company would be required to adopt and disclose a code of business conduct and ethics for directors, officers, and employees, and promptly disclose any waivers of the code for directors or executive officers. Each company would be permitted to determine its own policies but the NYSE noted that such a code should address, at a minimum, among other things: conflicts of interest, including prohibiting any loans or guarantees to directors, officers, or employees; corporate opportunities, including prohibiting directors, officers, or employees from taking for themselves personally opportunities that are discovered through the use of corporate information or position; confidentiality, including employees maintaining the confidentiality of information entrusted to them by the company or its customers; and fair dealing, including that no employee be permitted to take unfair advantage of anyone through misrepresentation of material facts.

4 Because certain types of securities do not present the opportunity for abuse that Rule 17j-1 was designed to prevent, money market funds, and funds that limit their investments to certain money market instruments, certain U.S. government securities, and securities of other mutual funds are not required to adopt a code of ethics and their access persons are not subject to Rule 17j-1's reporting obligations. Rule 17j-1(b) does, however, prohibit all fund personnel from engaging in fraud in connection with personal transactions in securities held or to be acquired by any fund (including those funds excepted from Rule 17j-1's code of ethics and reporting obligations requirements). See Investment Company Act Release No. 23958 (August 20, 1999) ("Adopting Release") at pp. 27-28.

Rule 17j-1's requirements specifically apply to any senior financial officer of the investment

company and any senior financial officer of its investment adviser. See Rule 17j-1(a)(1) (defining access person to include, among others, any director or officer of an investment company and any director or officer of the investment company's investment adviser).

5 See Rule 17j-1(d). The annual holdings report requirement was intended to improve the ability of fund compliance personnel and Commission examiners to detect illegal trading activity by fund personnel. See Adopting Release at p. 15.

6 Section 406(b) of the Act provides that "[t]he Commission shall revise its regulations concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the immediate disclosure, by means of filing such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers." Because investment companies are not required to file Form 8-K, this provision clearly does not apply to them. We note, however, that the boards of investment companies subject to Rule 17j-1 already are required to approve any material changes in codes of ethics under Rule 17j-1(c)(1)(ii). In addition, these investment companies already are required to disclose whether the investment company, its investment adviser, and principal underwriter have adopted codes of ethics and whether these codes permit personnel to invest in securities that may be purchased by the investment company. Moreover, these investment companies already are required to file their codes of ethics through the Commission's Electronic Data Gathering, Analysis and Retrieval system as an exhibit to the fund's registration statement. The Commission adopted this requirement to facilitate public access to investment company codes of ethics and to permit investors, market professionals and the financial media to obtain information about a fund's policies concerning personal investment activities. See Adopting Release at p. 25. These requirements more than satisfy the apparent intent of Section 406(b) to require companies to disclose to investors whether they hold their financial officers to certain ethical standards in their financial dealings. See Senate Report No. 107-205 (July 3, 2002) at p. 32 ("[t]he Committee believes that investors have a legitimate interest in knowing whether a public company holds its financial officer to certain ethical standards in their financial dealings.") ("Senate Report").

7 The issues and certification report requirement was designed to give investment company boards the opportunity to evaluate the effectiveness of codes of ethics and procedures and the manner in which they have been implemented. See Adopting Release at p. 11.

8 See Section 17 of the Investment Company Act.

9 See Section 17(a)(3) of the Investment Company Act.

10 See Section 17(e) of the Investment Company Act.

11 See Section 17(f) of the Investment Company Act.

12 See SEC Release Nos. 33-8124, 34-46427, IC-25722 (August 28, 2002).

13 We believe that the recommended approach is justified with respect to money market funds and funds that limit their investments to certain money market instruments, certain U.S. government securities, and securities of other mutual funds because these funds are subject to certification requirements and to Rule 17j-1's general prohibitions on fraud. See note 4, supra.

14 Section 406 of the Act.

15 See Senate Report at p. 32 (“[i]nvestors may find it relevant in making their investment decisions whether an issuer’s audit committee has at least one member who has relevant, sophisticated financial expertise with which to discharge his or her duties”) (emphasis added).

16 These matters include (1) an understanding of generally accepted accounting principles; (2) experience in (a) the preparation or auditing of financial statements of generally comparable issuers; and (b) the application of such principles in connection with the accounting for estimates, accruals and reserves; (3) experience with internal accounting controls; and (4) an understanding of audit committee functions.

17 Senate Report at p. 32. Of course, a person who meets the definition of a “financial expert” for an operating company should also qualify as a financial expert for an investment company.

18 Olivia F. Curtley, former Chair of the AICPA, in describing composition of audit committees during Senate Banking Committee hearings on Enron indicated that, “[i]f a member lacks sufficient expertise, he or she may not understand the issues, know the questions to ask, or have a basis for considering the adequacy of the response provided. In light of the increasing complexity of tasks, we also believe that consideration should be given to requiring at least one CPA with appropriate technical or industry experience to serve on the audit committee and, if this is not possible, then the audit committee should be encouraged to seek outside assistance or input on a regular basis from someone other than the auditor or management.” See Statement of Olivia F. Curtley before the U.S. Senate Committee on Banking, Housing and Urban Affairs (March 14, 2002).

19 Investment companies only estimate the value of their portfolio securities in the sense that they determine the “fair value” of those portfolio securities for which market quotations are not readily available. See Section 2(a)(41) of the Investment Company Act. The Commission and its staff have provided detailed guidance to investment companies on their responsibilities to fair value securities. See Accounting Series Release No. 113, Investment Company Act Release No. 5847 (October 21, 1969), Accounting Series Release No. 118, Investment Company Act Release No. 6295 (December 23, 1970), Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated December 8, 1999 and Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated April 30, 2001.